OMERS

A BRIEF TO

THE TASK FORCE

ON

THE INVESTMENT OF PUBLIC SECTOR PENSION FUNDS

PROVINCE OF ONTARIO

MARCH, 1987

ONTARIO MUNICIPAL EMPLOYEES RETIREMENT BOARD

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ONTARIO MUNICIPAL EMPLOYEES RETIREMENT BOARD
ONE UNIVERSITY AVENUE, SUITE 1000, TORONTO, ONTARIO M5J 2P1 (416) 369-2400

March 5, 1987.

Mr. Malcolm Rowan,
Chairman,
Task Force on the Investment of
Public Sector Pension Funds,
101 Bloor Street, West, 5th Floor,
Toronto, Ontario, M5S 1P7.

Dear Mr. Rowan:

On behalf of the Board of OMERS, I would like to thank you for your invitation to express our views on key issues in public sector pension investment. For your assistance, we are pleased to submit the attached brief and accompanying study that explores the broader issue of economic enhancement.

In our submission, we speak to a number of the important issues you have raised. However, the overriding concern of the Board is that the most fundamental issue of all be addressed -- namely, what is the proper role of any pension fund? It is our strongly held view that our role as a pension fund is to manage and invest the monies entrusted to us solely for the benefit of our present and future members. All other issues are secondary in importance.

We are very concerned that some of the initiatives being explored by the task force could undermine the fundamental rights of our members, and we urge you to assess all recommendations within this context. Some of our members have already expressed concern that new policies could radically alter their pension fund. They feel, quite correctly, that control of OMERS, and its future direction, should rest with the membership through the independent Board that represents it. In general, the feeling of the membership is one of comfort and satisfaction with the operation of their pension plan as it currently exists.

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We welcome the opportunity to participate further in this important process.

Sincerely,

C. M. Beckstead

C. M. Beckstead,
Chairman.

Attach.

OMERS: A PROFILE

Established by an Act of the Ontario Legislature in 1962, the Ontario Municipal Employees Retirement System is a pension fund serving a diversified membership of employees of local government.

At present, 1,069 municipalities, local boards and schoolboards participate in OMERS. This represents 140,111 contributing members and 33,340 pensioners. OMERS also manages the pension plans of Ryerson Polytechnical Institute and the Colleges of Applied Arts and Technology on a fee basis.

Financed entirely by contributions from member municipalities and their employees, OMERS is a fiduciary acting on their behalf -- not an agent of the provincial government. None of the provincial grant money to municipalities is specified for OMERS, and local governments join our plan at their own option.

To meet its obligations to present and future members, OMERS must invest their funds and reinvest the returns prudently and effectively.

OMERS is a defined benefit plan, but ad hoc increases and improvements to retirement benefits have been made over the years without any increase in member and employer contribution levels. These improvements to the pension benefits were made possible by sound and stable financial planning and because of the strong investment performance of the OMERS Fund.

OMERS' fund currently has a market value of $8 billion and is invested in a widely diversified portfolio of capital market investments including equities, bonds, short-term money market securities, mortgages, real estate, term loans and venture capital. During the past five years, the compound rate of return on the fund was 19% per annum, compared to the S.E.I. Comparative Measurement Service median fund return of 17.4%.

OMERS is managed by a Board whose members are appointed by the Lieutenant Governor in Council on the recommendation of the Treasurer of Ontario. The Board is unique to the pension world as well as the public sector area in that the majority of the members of the Board are employees of local governments contributing to the plan. Other members are elected or appointed officials of municipalities and local boards of municipalities. Thus OMERS is managed by and for local government employees and employers with the sole and dedicated purpose of providing an adequate retirement income at stable and reasonable contribution rates.

The 25 year history of OMERS as a multi-employer pension plan with the single objective of managing the retirement income of municipal and local board employees and retirees in Ontario has proven very successful and the Board and staff have achieved a high level of "trust" with members, retirees and employers.

EXECUTIVE SUMMARY

In this brief, OMERS responds to some of the critical issues being explored by the task force as it studies the role, responsibilities and direction of Ontario's public sector pension funds.

Our key points can be summarized as follows:

0 The primary responsibility of a pension fund -- whether public or private --is to provide retirement income to its present and future members.

0 OMERS fulfills this responsibility by operating soley as a pension management business and making investment decisions according to sound business principles.

0 OMERS has achieved an excellent track record and above average returns which have allowed for improvements to benefits.

0 Through its successful performance, OMERS has made a number of major contributions to the economic enhancement of Ontario:

- stimulating economic growth by financing large and small enterprises.
- contributing to the liquidity and efficiency of the financial markets.
- providing financing for government programs, including socially-assisted housing programs.
- launching major real estate projects, creating jobs in the construction sector.
- providing term lending, venture capital and other creative financing programs in support of technology development and entrepreneurship.
- strengthening Toronto's position as an international financial centre through our extensive trading activities.

0 Investment in the capital markets has been very successful for OMERS, but our experience indicates that the phasing of large funds into capital markets from non-marketable investments should be approached with care and conducted in an orderly fashion to avoid disruption of the marketplace. This also applies to the considerations of new approaches for the investment of Ontario's share of Canada Pension Plan funds.

0 Although some centralization of management for small public sector funds would permit greater efficiencies, we believe that full centralization of public sector funds in Ontario could be detrimental. Such a move could:

- make it very difficult to recognize the unique needs and characteristics of different groups of public sector employees;
- result in the ownership of private businesses being concentrated in even fewer hands;
- limit the amount and sources of pension fund financing available to Ontario businesses;
- impair the liquidity and efficiency of the capital markets.

0 While economic enhancement is a worthwhile goal, OMERS would strongly oppose any policy attempting to direct public sector pension funds into specific investments. We believe that such a move would hamper our ability to fulfill our fiduciary responsibilities to our members. Our experience has been that where we have been free to participate in well thought out framework programs (like NHA non-profit housing), we have been able to serve the needs of our members as well as those of society.

In doing so, OMERS has contributed substantially to Ontario's economic development.

OMERS' RESPONSIBILITIES AND OBLIGATIONS

OMERS has one overriding responsibility -- the provision of post retirement income to present and future members.

That responsibility is our mandate and the reason for our existence. OMERS was formed 25 years ago for this very purpose, and member employers and employees have entrusted us with their funds on that basis. We are in a position of trust, and we have a moral and legal obligation to meet our long-term commitments. In this vital respect, we believe there is no difference between public and private sector funds -- nor should there be.

We believe absolutely that public sector employees have the same fundamental rights in terms of investing in their future as employees in the private sector. The monies that members contribute are held in trust and managed for their benefit. We are proud of the fact that in meeting this responsibility, OMERS has established a record of steadily improving benefits.

In meeting our obligations, we operate within a broad framework of social responsibility and accountability -- abiding by the letter and spirit of the law, reflecting the values of our members and participating in public policy debates. At the same time, we have provided substantial and visible benefits to our country, our province, and to the communities we serve.

OMERS' BUSINESS PRINCIPLES

OMERS' operations are geared towards accomplishing our primary goal. To this end, we operate soley as a pension management business, according to sound business principles.

Our fundamental investment objective is to achieve, within the limits of prudence, the best possible returns over the long term with the funds entrusted to us.

To maximize returns while minimizing risk, we have developed a broadly based investment portfolio that is widely diversified by region and by industry. It also reflects a mix of long and short-term investments, ensuring both flexibility and stability.

OMERS' TRACK RECORD

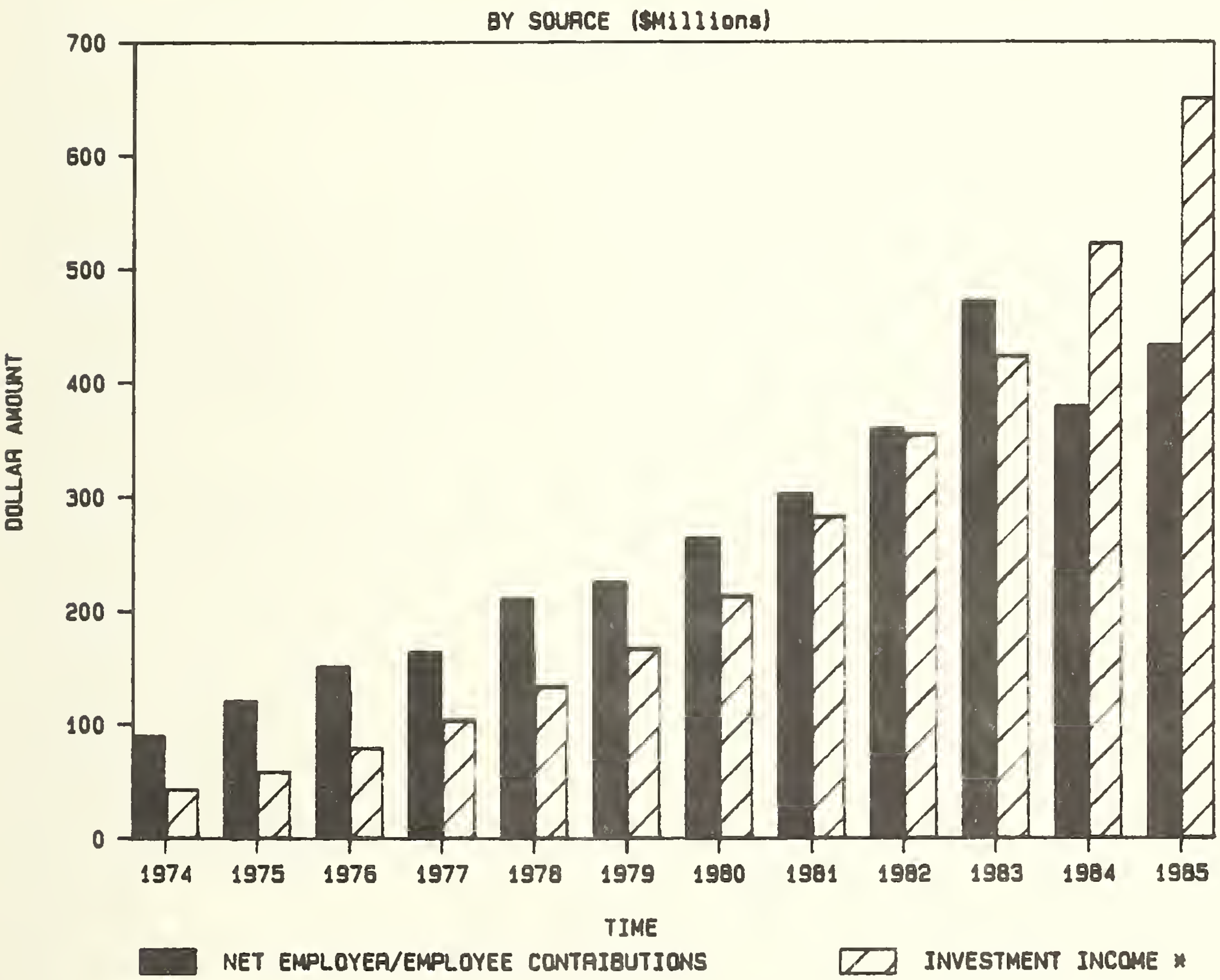
OMERS' principles and investment approaches have served our membership well.

As the chart indicates, the fund has grown at a rapid pace in recent years, with investment income now exceeding contributions. OMERS has done so by investing wisely in the capital markets.

This performance has allowed for ad hoc increases and other enhancements to retirement benefits from OMERS' own financial resources. Increases in basic benefits have averaged 4.3% a year since 1980, spousal benefits have been strengthened and made more equitable, and special early retirement pensions have been introduced.

At the same time, OMERS' performance has made a significant and important contribution to the economies of Ontario and Canada.

OMERS' ANNUAL INCOME: 1974 - 1985



* Includes cash income from interest, dividends, etc. plus gains realized upon sale of securities

OMERS' CONTRIBUTION TO ECONOMIC ENHANCEMENT IN ONTARIO

While economic enhancement is not the purpose of OMERS, it has certainly been the effect of our successful performance. We view economic enhancement in broad terms, as detailed in the attached study. In those terms, our contribution has been extensive.

a) Providing Post Retirement Incomes

Pensions administered by OMERS are a crucial source of retirement income to our members. This income helps pensioners maintain their standard of living, permitting them to continue their own contributions to Ontario's economic enhancement by purchasing goods and services, or by channeling a portion of their income into personal savings and investments.

Our record of steady benefit improvements has been achieved without increasing the rates of contribution by employees and their municipal employers.

b) Financing Government Programs and Capital Works

We support the ongoing operation of government programs and capital works projects through the purchase of marketable government securities such as Treasury Bills and bonds. The contribution to the Ontario economy has been direct -- municipal, Ontario Government and Ontario Hydro securities, for example -- or indirect, by way of purchasing Government of Canada securities to finance programs which benefit Ontario as well as other provinces.

We also support properly structured special purpose government programs, such as the NHA mortgage program. With more than $1 billion invested in residential mortgages, we are a major source of funds for residential construction. And OMERS is perhaps the largest single source of funds for the Federal Government's NHA non-profit housing programs, which makes affordable housing available to Canadians of limited means, while offering a competitive rate of return to investors. These units are built and managed by charitable foundations across the country and, in addition to providing affordable housing, they create employment in our construction industry. At the end of 1986, OMERS had nearly $600 million invested -- of which two-thirds was invested in Ontario.

c) Commercial Real Estate and Urban Development

OMERS participates with the private sector in the financing of commercial, industrial and retail construction, primarily through direct and pooled real estate investments and through commercial mortgage leading.

Not only do these activities generate good investment returns, they also help to create employment in the construction industry and contribute to municipal development and redevelopment. For example, we have participated in a project to provide space for small office and warehouse users at Nolan Court in North York and in a new office and retail development at the Oakville Corporate Centre.

A more recent and more ambitious project has been the completion of the first of several phases of the Constitution Square office project in Ottawa. Involving the redevelopment of a major piece of the downtown core, the project will provide first class office space to dozens of corporate and government tenants in the nation's capital.

d) Contributing to Financial Market Liquidity

At the end of 1986, OMERS had a total of $4 billion invested in marketable securities, such as stocks, bonds and money market instruments. Of this amount, $783 million represented net new money which flowed into the markets during the year. (An additional $352 million in net new funds went into investments such as mortgages, term loans, real estate, foreign markets and special situations).

The majority of our extensive trading activity has been centred in Toronto, and has helped enhance the city's status as an international financial centre. At times, OMERS has accounted for as much as 40% of the daily trades on the Toronto Stock Exchange.

Investment activity on this scale contributes substantially to the liquidity of the markets.

Without liquid or efficient markets, companies and governments would have a much more difficult time raising capital, which can be put to productive uses by financing major projects or expansion programs.

An especially rewarding area of activity for OMERS has been our Growth Equity Program, where we participate in financing smaller publicly listed Canadian companies. For example, we invested in the initial public share offering by Linamar Machine Ltd., a high technology company located in Guelph, Ontario. Our participation helped provide growth equity to Linamar and we, in turn, have benefitted from outstanding investment returns.

e) Supporting Small Business

The financing needs of small businesses vary greatly, and often require creative approaches. Apart from our Growth Equity Program, OMERS supports the growth and development of small business in a variety of ways. These include:

* Term Loans: OMERS has $135 million invested in term loans -- of which 51% represent loans to Ontario companies or to companies that are national in scope but based in the province.

* Venture Capital: OMERS, along with other public and private sector pension funds, participates in several pooled funds that are managed by experienced venture capitalists and channelled into numerous business start-ups, refinancings or expansions in Ontario. Our participation in this area at present, however, is limited by the small number of qualified Canadian investee companies in whom our pooled funds can make investments.

f) Financing Resource Development

OMERS also participates with other public and private sector funds in purchasing and developing oil and gas producing properties throughout Canada. The properties are managed by industry partners and our involvement helps provide capital to a strategic industry that is often prone to severe cyclical swings. One of our most successful ventures in this area is LASMER Resources, jointly owned by OMERS and LASMO, the Canadian subsidiary of a U.K.-based energy firm. Together, we identify promising properties for purchase and development and have succeeded in operating them profitably.

g) Special Situations -- Some Success Stories

Not all of our so-called "marketable" portfolio is invested in companies or situations where there are liquid or efficient markets for their securities. OMERS participates in a variety of capital market "niches" where we must be prepared to be patient with our investment. But patience can be rewarded. Some examples include:

* Co-Steel: An Ontario-based company with a technologically advanced process for steelmaking and with international operations. Co-Steel needed capital to weather the last recession. OMERS was the lead investor in a private placement of shares at the time. With earnings growth restored, the company recently went public and OMERS has profited handsomely.

* American Can Canada Ltd. (now Onex Packaging) and Purolator Canada:
  Two subsidiaries of foreign owned firms, with substantial operations in Ontario, were repatriated by a unique vehicle called Onex, where public and private sector funds participate with a private sector firm in identifying attractive leveraged buyout situations.

* Trailmobile: A Brantford-based company in the automotive sector provides another example of a foreign-owned subsidiary that was repatriated with the help of public and private sector pension fund financing. In this case, the investment took the form of a term loan.

KEY TASK FORCE ISSUES: RESPONSE AND COMMENT

1. Capital Market Investments

Without question, investing in the capital markets has been a major reason for OMERS' rapid growth and successful performance.

Our growth rate began to accelerate in 1976 as we began our move into the marketable securities area, and increased year by year as we ceased purchasing non-marketable Ontario debentures.

From the fund management point of view, the capital markets offer stronger growth potential, greater flexibility in terms of meeting long and short term commitments, and the opportunity for broad diversification, as a means of controlling risk.

From the economic enhancement point of view, we believe the benefits have been significant.

OMERS' gradual phasing into marketable securities -- by drawing on progressively larger portions of funds available between 1975 and 1979 -- was achieved without disruption of the marketplace. Moving slowly and cautiously was crucial to the process. The transition of other major pension funds to the capital markets may be desirable, but careful consideration must be given to the impact on the marketplace. The same caution should be exercised as new investment approaches are considered for Ontario's share of Canada Pension Plan funds.

2. Centralization of Funds

While OMERS' size as a centralized fund in the local government sector has been an advantage in many respects, we believe that full centralization combining all of Ontario's public sector funds could be counter-productive and detrimental to the marketplace and to the pension plan members.

Essentially, we believe that it is healthier to have several public sector players in Ontario -- each with different approaches or different areas of investment expertise -- than one mammoth player that would dominate and thereby distort the marketplace.

In our opinion, neither the markets nor the economy would benefit from even greater concentration of ownership or investment decision making in Canada.

Furthermore, we believe that full centralization would have disturbing implications for the role of pension funds. A pooling of existing investments from several funds could make the resulting fund a major shareholder with a potential controlling interest in a number of publicly traded companies. Having such control is not in our mandate.

Also, current rules for pension investment prevent funds from participating in more than 30% of the capitalization of any one company. In many cases, prudence might dictate less exposure to a particular company. However, collectively, there may be situations in which public sector funds as a group could own in excess of 30% of a company's equity. Merging the funds might prompt substantial (and potentially disruptive) divestiture. It also might limit the number of future investment opportunities available to the new fund.

The 30% ownership limit would especially limit the amount of pension fund financing available to smaller businesses in the event of consolidation of Ontario's public sector funds. To replace several funds with one fund would automatically reduce the number of potential financing sources.

There are also implications for our ability to meet the specific needs of our membership. The membership of every fund has a unique demographic profile, and we structure our investments accordingly -- with the right mix of investments to ensure that we meet our future commitments as and when they arise.

However, we do believe that some centralization -- of smaller funds -- could have positive results. OMERS' experience has been that, to a point, pooling of resources creates substantial operating efficiencies. Our concern is with the creation of a massive fund where size could become a major obstacle.

We have already discovered that, as the CAAT and Ryerson plans have grown, so too has the interest of their Boards of Trustees in establishing their own independent investment operations. OMERS understands well their desire to take a more active role in serving their memberships in this way and we believe this would be a positive development for them, as well as for the capital markets and the Ontario economy.

3. The Economic Enhancement Issue

Governments have the right -- indeed, the obligation -- to develop policies which further the economic and social development of society. Our own experience has been that well conceived framework programs are most successful when they encourage (rather than direct) pension funds to participate in key areas (like non-profit housing or resource properties development). In that way, the needs of the plan members, as well as society as a whole, can be served.

We feel very strongly, though, that Ontario's public sector pension funds should not be directed into specific investments as part of an economic enhancement program for the province.

Relative freedom of fund management, allowing us to make investment decisions for business reasons, has led to successful performance which in turn has sparked economic enhancement.

We are very concerned that being directed into specific programs -- and being governed by policy goals rather than sound investment criteria -- would:

0 restrict our ability to select the best possible investments for our portfolios, thereby contravening our fiduciary responsibilities.

0 reduce prudent diversification by region, leaving us more susceptible and vulnerable to regional downturns -- again, in contravention of our responsibilities. The Ontario economy, because of its structure, tends to be cyclical. Indeed, our own experience has been that wide diversification of assets -- both regionally and internationally -- has been in the best interests of our members.

0 increase regional disparity and divisiveness in Canada -- which would ultimately have a negative impact on Ontario's markets.

Economic enhancement may be achieved in many ways, but no policy should be allowed to undermine the fundamental rights of a pension fund's present and future members.

CONCLUSION

Clearly, the issues being studied by the task force are important ones. They are also very complex, and any recommendations could result in actions that will have impacts -- good or bad -- on the retirement needs and aspirations of plan members, on the efficient management of the funds, on the marketplace, and on the economy.

We therefore urge the task force to study the implications of major shifts in policy very carefully. A great deal is at stake -- including the retirement income of Ontario's public employees.

Our main concern must be for them.

ATTACHMENT

PENSION FUND INVESTMENT AND ECONOMIC ENHANCEMENT

A STUDY

PREPARED FOR OMERS

BY

DR. ARTHUR J.R. SMITH

PENSION FUND INVESTMENT AND ECONOMIC ENHANCEMENT

By Arthur J.R. Smith*

EXECUTIVE SUMMARY

The Task Force on the Investment of Public Sector Pension Funds has been asked, among other matters, "to determine whether economic development in Ontario could be increased through changes to the way public sector pension funds are invested".

In approaching any such determination, it is important to understand the meaning of economic development (or economic enhancement, as it is frequently called today), and of the role that investment in general may play in achieving such enhancement.

Economic enhancement is, of course, only one of the fundamental aspirations of a modern society. Its achievement requires sustained and consistent attainment of high income growth, high levels of employment, reasonable price stability and a broad sharing of the fruits of economic progress. Real (i.e. "inflation adjusted") income growth, based on productivity improvement, needs the highest priority to achieve overall economic enhancements. Investment is a key factor in productivity growth.

Rates of return on investment are widely perceived to be the primary institutional mechanism through which savings generated in the personal, corporate, government and international sectors are invested to yield productive results for society. Although "pure market tests" do not govern all savings-investment allocation processes, government (and other) involvements in investment-influencing activities have generally been powerfully shaped by the underlying realities of market forces.

The world environment for economic enhancement has changed substantially during the past decade, with a significant slowing in world economic growth, a continuing relative shift of demand, employment and output away from goods and towards services, sharp intensification of competition (especially in manufacturing), and wide-ranging development and use of new technologies. In these conditions, there has been a sharp acceleration in the rates of birth of new and small organizations, and considerable difficulties for many larger and more mature organizations to adjust to the new economic realities.

Rapid world-wide introduction of new product and process technologies, and the success with which Ontario can adopt new technologies, will have an important bearing on Ontario's economic progress. Also important will be the probable maintenance of a relatively open international economy as well as pitiless international competition.

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* Dr. Smith is an economist who has served in the private and public sectors, both in Canada and internationally. He was on staff at the U.S. Federal Reserve Board, is a former Chairman of the Economic Council of Canada, a former President of the Conference Board in Canada and has served as a director of several well known Canadian companies.

New focus has emerged on the qualities of management and the educational and skill qualities of the labour force as key factors in the achievement of productivity growth.

Financial intermediaries are growing in overall relative importance, as institutions that can help to allocate resources to productive uses, reflected in high rates of estimated returns. Although the Ontario Public Sector Pension Funds can play only a small part in the broad spectrum of savings-investment allocation processes, it is appropriate to ask whether that role can be increased. The present heavy concentration of the assets of these Funds in nonmarketable securities suggests that there is a potentially larger and more wide-ranging role for these Funds to play in the overall development of the Ontario economy. But in the evolution of any such larger role, there clearly must continue to be overwhelming attention in the management of assets to their best use for ensuring present and future retirement benefits for Ontario public sector employees.

Fundamental Goals of Public Policy

Before beginning any consideration of the goal of economic enhancement, it is important to recognize that there are other fundamental goals that must be pursued simultaneously in the interests of the broad welfare of Ontario's people. These include:

- The pursuit of cultural progress, creativity, diversity and excellence;
- The maintenance of strong democratic traditions and institutions, with a sound basis of justice and equity;
- The enhancement of the environment, not only of nature, but also of the man-made surroundings in which most Ontario people will live for most of their lives; and
- The improvement of education and health care.

These are large and multifaceted goals that defy ready definition or easy solutions. Progress their achievement is a continuing but complex process, assisted by various important elements of synergism, but also constrained by competition and conflict among them.

Economic Enhancement

On closer examination, economic enhancement reveals itself to be a complex of basic, and not easily reconcilable, goals. A scanning of the literature on economic development, especially over the twentieth century, suggests that sustained longer-term success in achieving economic enhancement is predicated on four fundamental economic and social goals. They are as relevant to the Ontario economy as to any other, and can be summarized briefly as follows:

(1) growth in real (i.e. "inflation adjusted") per capita income in Ontario;
(2) a high level of Ontario employment, and effective opportunities for harnessing human talents, skills and experience;
(3) reasonable price and cost stability;
(4) a broad sharing among all people in Ontario of the fruits of economic progress.

Since, these goals and the policies to achieve them are not always readily compatible, none of them should be pursued as a pre-eminent goal. A strong, single-minded pursuit of price stability, for example, can be inimical to the achievement of income growth and high employment; the pursuit of high employment can be adverse to the maintenance of cost stability and competitiveness.

The complexity of economic relationships ensures that these goals cannot be pursued in isolation. This is especially true of Ontario whose economy is cyclical and widely linked to economic enhancement (or the lack of it) in other parts of Canada, the United States and beyond.

Given the conflicts and trade-offs in the pursuit of multiple goals, some dimensions of economic enhancement vie with other broad social and human objectives, especially in the allocation of resources - human, material and financial. Yet such development also generates income and wealth that can be used to contribute more effectively to successful progress towards other goals.

Growth of Real Income: Productivity

On balance, evidence suggests that one of the above four goals should have priority (but, not pre-eminence) in any serious thinking about economic enhancement in Ontario. This is the goal of growing per capita income which, in the long run, rests on "productivity growth", broadly defined as rising output of goods and services in relation to the productive resources deployed in generating them. Productivity improvement is the ultimate, long-run source of growth in living standards. It also has important reconciling capabilities for ensuring better performance among other economic enhancement objectives and other societal goals.

Sustained productivity improvement has been demonstrated to foster better price and cost stability. By working towards maintaining or improving competitiveness, such improvement also facilitates job creation and job maintenance. Growth in the size of Ontario's overall "economic pie", makes a major contribution to easing the process of achieving more equitable distributions of real income and wealth. Without such growth, redistribution, however socially desirable, must take place only in the cramping situation of redistributing against some people in favour of others.

Even further, any society in which sustained growth in income (and wealth) is taking place, is a society that can more richly and independently afford to pursue cultural distinctiveness and identity, more ambitious frontiers of environmental standards, of health care and education, and progressive social policies.

Thus, the growth of income of the people of Ontario is the most fundamental objective to address in the Task Force's terms of reference relating to economic development.

This is not to say that productivity improvement is the only means for improving per capita income. A long-term rise in export prices relative to import prices can raise incomes, although such gains cannot be achieved indefinitely into the future and may even be reversed. Discovery of rich new resources may also provide a basis for accomplishing widely distributed economic advances, but any economy will inevitably find it difficult to capture and hold such gains over an extended period of time. In fact, among the various ways to achieve economic development, the most basic and assured route is through the increasingly productive use of resources available for producing goods and services. Such production processes yield income and wealth to be shared among all those who contribute resources -- and, if there is a good margin of productivity improvement, there will also be more income to share among those who are not contributing directly to such improvement. In short, the essence of productivity growth is that there will be "More to Share".

Factors Contributing to Productivity Growth

What, then, are the basic resources that contribute, through productivity growth, to gains in income? Over the decades, the answers to this question have been varied and confusing -- ranging from:

-- highly simplistic measures of output per worker, to more complex concepts and measures of "increasingly effective combinations of land, labour and capital" in production;

-- to highly sophisticated statistical and technical structures of analysis focussing on changing quantities and qualities of "outputs" in relation to qualities and quantities of "inputs" (such as, the numbers, skills, education, experience, managerial know-how, etc. of people; the amounts, quality and up-to-dateness of capital used; the nature of new technology and the speed with which it is diffused and applied; etc);

-- to skills and practices in the marketing, engineering, organization, planning, pricing, product design, product quality, plant lay-out, inventory management, organizational reporting structures, accountability systems, automation, research and development, etc.

-- to wide-ranging human resource management and participation issues (recruiting and retention of good managers and employees, skill training and development, management styles, motivation and attitudes, rewards for accomplishment, pride of achievement, etc.)

Investment Facilitates Productivity Growth and Economic Enhancement

From this vast welter of innumerable, sometimes conflicting, and almost invariably confusing, approaches to identifying, clarifying and prioritizing the factors contributing to improved productivity performance, there is a perspective that is perhaps particularly useful and relevant to the Task Force's central concern about pension fund capital allocations to foster Ontario economic development. In this perspective, capital becomes the focal point around which to organize concepts. But

it involves a broad and multidimensional view of productive "capital", of which the two most important components are:

-- human capital (in the form of the existence and potential development of creativity, energy, skills, knowledge, dedication); and
-- physical capital (in all forms of public and private buildings, other structures, machinery and equipment including qualitative characteristics such as state of technology embodied in such capital).

The investment policies and performance of pensions funds contribute to economic enhancement through the "financial veil" of allocating funds under their management control. At least indirectly, these allocations contribute to improving the qualities of human capital through the embodiment of skills and knowledge in people via education, training and re-training. More directly, they contribute to the building up of the qualities and diversities of the physical capital stock. This has been accomplished through their management efforts to seek long-term high rates of return on their assets consistent with their basic goal of ensuring long-term retirement benefits for their beneficiaries.

Together, the funds have obviously played a substantial role in directing personal savings into a variety of government and private investments, ranging from the financing of government programs through bond purchases, to residential mortgages, commercial real estate, development of resource properties, and business startups and expansions. But even together, they account for only a rather small part of the whole volume of savings available (from personal, corporate, government and international sources) for capital investment.

Savings and Investment

In traditional national income accounting, investment is financed by savings from four basic sources:

- the personal sector (households, unincorporated business, farms, etc.),
- the corporate sector,
- the government sector, and
- the international sector.

The Ontario public sector pension funds are essentially involved in channelling a portion of the personal savings and government pools back into all four sectors:

- into the personal sector, especially in residential housing;
- into the corporate sector, through investment in commercial mortgages, corporate bonds and equities;
- into the government sector, through investment in provincial, federal and municipal government securities; and
- into the international sector through acquisition of foreign securities.

For geographic, climatic, economic and other reasons, Canada is a country that has needed particularly large amounts of investment. For example, cold weather tends to increase investment in houses and other structures. The long east-west ribbon of settlements in the South and the sparsely populated northern hinterlands require relatively heavy investment in transportation systems (rail, road, air, pipeline and water) and in communication and energy grid systems. These all need large "infrastructure investment" and maintenance. Canadian climate and population distribution have also made a high energy-using country, necessitating large investments in capital-intensive energy production. Historically, our economy has been largely shaped by, and continues to be greatly involved in, the so-called primary industries -- agriculture, forestry, fishing, mining and oil and gas production. These are all investment-intensive industries, as are resource processing industries such as smelting and refining, steel, pulp and paper, and basic chemicals.

Many major secondary manufacturing industries, such as automobiles and heavy machinery, are also capital intensive.

Still further, limited domestic markets, along with limited access to foreign markets, have imposed shorter production runs on many Canadian manufactured products, compared with those in the United States, Japan or Europe.

With the possible exception of Norway, Canada has the most investment-intensive economy among the world's economically advanced countries.

Because Canada has a high investment economy, it has historically sought to be a high savings economy. Compared with the United States and many European economies, it has in fact, achieved relatively high rates of personal and corporate savings. Yet, for much of its history, domestic savings have been inadequate to meet pressing investment needs. As a result, foreign savings (net foreign investment), as well as other international productive resources, have been drawn heavily into Canadian economic development.

Rates of Return

Since the earliest times in Canada, rates of return on investment have been the primary institutional mechanism through which savings have been allocated to investment. Such rates of return take varied, and frequently combined, forms in the capital markets -- interest rates, dividends, capital gains, profitability, etc. These are all currently and prospectively assessed in myriads of types of investment decisions and investment vehicles.

"Pure market tests" do not, of course, govern all allocation processes. Business firms, for example, redeploy retained earnings without any formal market tests, but such decisions are generally made with sensitivities to alternative opportunities for investment having regard to rates of return. Households and governments, too, invest their own savings. But generally, households and governments accomplish a

significant part of their investment through financial intermediaries and financial markets in which millions of savings-investment linkages are made.

Government Involvement in Investment

Government involvement in savings - investment processes has been varied and complex. Such basic constitutional powers as the federal powers in the field of money and banking, and the provincial powers in the field of the protection of persons and property, have provided the bases for extensive legislation and regulation of national and provincial financial affairs and institutions. Indeed, the scope and range of government involvement in such matters defies any ready description. It ranges:

- from direct investment by governments;
- through the establishment and support of crown corporations (including corporations especially designed to foster flows of savings into particular sectors of the economy -- such as housing -- or into particular activities such as venture capital financing, or into particular regions or sub-regions);
- "steering" savings into such special purpose vehicles as RRSP's;
- more focussed grants and incentives to encourage research and development, rental housing construction (e.g. MURB's), oil and gas exploration and development, film making, etc.;
- "screening" foreign investment (e.g. FIRA);
- legislation governing the roles and investment policies of financial institutions, such as banks, insurance companies, trust companies, investment companies, pension funds, credit unions and co-operatives; and
- governance of the operations of securities markets.

Many broad public purposes have motivated such government involvement in the shaping of investment patterns -- not only economic enhancement and job creation, but also preserving the soundness and stability of financial institutions and markets, the need for prudence in the management of financial assets (especially those managed by institutions with fiduciary responsibilities), the narrowing of regional disparities and the remedying of actual or perceived market imperfections.

Yet, such government involvement has also been powerfully shaped by the underlying realities of market forces that drive financial, as well as material and other, resources towards high rates of return in relation to risks involved.

Basic Changes in the Environment for Economic Enhancement

During the past decade, the environment for economic enhancement has been substantially changed by a world-wide slowing of economic growth (especially productivity growth), by long-lasting effects of the industrial recession of 1981-82, and by an apparent growing acceptance of slow growth prospects, at least for the medium-term future.

This change in environment partly reflects four fundamental forces that are combining to reshape our modern economy and society:

- growing demand for personal and business services in relation to demand for goods;

- a world-wide slowdown in the underlying growth rates of many resource-based industries, accompanied by large and troublesome imbalances in demand and supply for many of the products of such industries;

- an extraordinary intensification of international competition, particularly for manufactured products, among the industrially advanced countries and between these and the newly industrializing countries (especially the Pacific Rim countries); and

- wide-ranging development and implementation of new product and process technologies.

Rapid transformations are taking place in these conditions -- and the fastest changes generally appear to be occurring among those countries experiencing the fastest rates of growth in real per capita income.

These fundamental forces have had tremendous impacts on economies -- perhaps as strongly felt in the Ontario economy as in any other economy in the world. Together, they have not only slowed over-all growth rates, but have also created huge and complex problems of economic adjustment, generated serious imbalances (economic and financial) on a world scale, and increased the uncertainties and risks of both government and private decision-making.

But they have also created new opportunities. One striking phenomenon of the past decade has been a remarkable upsurge in the establishment and development of new and small as well as medium-sized business enterprises. In spite of the absence of precise and up-to-date data, it is widely believed that well over half of net new job creation (some would claim most of it) is taking place in small enterprises (with less than 20 employees). This is not a uniquely Canadian phenomenon. Sharp acceleration of new and small business formation has apparently taken place among most industrialized countries in the 1970s and 1980s.

Whether this surge has been accompanied by an equivalent rise in real income and wealth in the small business sectors of economies is less clear, especially since the accompanying increases have had relatively large components of part-time and relatively low-wage employment, mainly in service industries.

In addition, the rising rates of new and small business creation, have been generally associated with high mortality rates among such enterprises. The great majority of such business either fail, or at least fail to prosper, within a couple of years of their birth.

Among more mature and larger enterprises, there have also been great opportunities for growth -- especially through the development of new

products and services, through market strategies that have linked production to growth markets in various parts of the world, through effective efforts to improve competitiveness and market share and through the exploitation of new technologies.

On the other hand, many larger and more mature organizations have encountered great difficulties in adjusting to new economic realities, especially the more capital-intensive mining, resource-processing and manufacturing industries. These difficulties are evoking extraordinary efforts to implement new product and new process technologies, to develop or redevelop human skills, and to apply high qualities of management skills to rapid re-organization of business practices, operations and structures.

Yet, it is not only in organizations under stress, but throughout all organizations in our economy, that we need ongoing processes of innovation and rejuvenation in addressing the challenges of increasing complexity and rapid change. Indeed, for an economy as a whole, as well as for organizations within it, the prospects for slower growth reinforce the need for changes to improve productivity and competitiveness.

New Technologies

The use of new technologies has become a highly visible theme in much of the discussion about economic enhancement. But much of this discussion is confusing. The following are a few important perspectives about the role of new technologies in this context:

(1) There is no "economic enhancement magic" in "high tech" *per se*. Nevertheless, it is an integral component in many aspects of improving productivity and competitiveness.

(2) While it is vital to continue to strengthen domestic R&D capabilities, it is even more vital to maintain clear perspective on the fact that the economic enhancement of Ontario will depend much more heavily on the *adoption*, rather than on the *invention*, of new product and process technologies. Such enhancement will be furthered by more emphasis on the adoption of new *product* technologies.

(3) There is some evidence that Canadian industries have not kept pace with foreign producers in adopting new technologies.

(4) An overwhelming proportion of the new technologies adopted to enhance Ontario's economic development will not only be discovered, but also first implemented, outside of Ontario (and also outside Canada). Open doors for technology inflows are therefore crucial.

(5) The main arena of technological change in an industrially advanced economy is that of the design and re-design of products and processes in medium and larger organizations. It is mainly in this arena that such immensely important new "generic technologies" as information technology, materials technology, energy technology and bio-technology are now occurring.

(6) In the case of information technology, the world is now experiencing a fundamental technological revolution, of the order of the so-called industrial revolution of the nineteenth century. Elements of this revolution have, during the past decade, gone well beyond a few leading edge industries, and are now flowing through all areas of production of goods and services. More basically, the thrust of industrial change has clearly begun to shift away from materials-intensive and energy-intensive frontiers to more information-sensitive frontiers. Moreover, the world appears still to be in the early stages of this information technology revolution, a revolution that is apparently accelerating, and one that is evolving with more workplace-oriented than household-oriented focus.

(7) There is little evidence of an overall shortage of financial capital as a reason for slow adoption of new technologies; gaps in the availability of funds are difficult to identify. Perceived gaps in new and small business financing are, for example, difficult to reconcile with the remarkable acceleration in the growth of new business formation over the past decade.

The More Open World Economy

In the pursuit of peace and prosperity after the Second World War, deliberate decisions were taken jointly among countries to create and preserve a more open approach to international economic and financial relationships. There was a strong collective will to avoid returning to the burdens of the economic insulations and the dangers of the political isolations of the pre-war period. The economic and social costs of protection in the prewar years had turned out to be much greater than most people had believed.

Today's world has, in fact, become an even more open one than was envisaged a few decades ago -- more open, not only for international flows of goods and services and for savings and investment, but also for travel and for flows of skills, knowledge, human creativity and technology. In other words, it has become a more open world for international flows of inputs as well as outputs.

Ontario has gained much from this more open world. The people of Ontario undoubtedly have a much higher average standard of living and a much more progressive society than they otherwise would have achieved.

Although many factors including slower world economic growth and large international financial and trade imbalances, have generated more protectionist tendencies during the past decade, it appears unlikely that there are imminent dangers of major protectionist measures that would create widespread, abrupt and deep dislocations in the Ontario economy.

The future enhancement of the Ontario economy should thus be viewed in the context of international economic and financial relationships that will continue to provide opportunities for the vigorous pursuit of benefits via such relationships. It will also continue to require sensitive and timely adjustments to the challenges of external competition and change.

New Focus of Productivity Factors

The growth of real income and wealth through productivity gains is the ultimate key to the economic enhancement of Ontario. To achieve such gains there must be sustained efforts within organizations to adjust combinations of productive resources in the most effective ways to increase their productive potentials. There must also be favourable conditions to encourage flexible flows of limited resources between organizations from lower productivity to higher productivity uses -- from less rewarding to more rewarding employment (actual or potential).

Fundamental to the achievement of both of these, as has become increasingly evident around the world over the past couple of decades, are two critically important factors: the quality of management (especially the management of people, risk and organizational and technological change); and the education, training and re-training of the labour force.

Large and intensified efforts have been devoted to strengthening management capabilities -- to the teaching and learning of management skills, to enlarging the bases of management knowledge, to the development of management experience, to the processes of management selection, retention and retirement. Large and growing public and private resources have also been devoted to improving the quality of the labour force, in terms of basic education and more forward-looking training in (and for) the workplace. Increasingly effective results from such efforts are imperative for Ontario's future economic progress.

In this context, the flow of savings into investment -- contributes, at least indirectly, to "human resource development" and, more directly, to the building up and maintenance of physical capital stock. More important, perhaps, the investment decision processes -- especially those that are strongly influenced by market-based rates of return on investment -- inherently help to allocate productive resources to managers who are perceived to be able to use such resources most effectively. The other side of this coin is that high quality management inherently tends to be more successful in attracting investment.

Financial markets and financial institutions play a key role in these processes, and by doing so, contribute to the economic enhancement of Ontario.

The Economic Enhancement Role of Financial Intermediaries

Canada's financial intermediaries (banks and near banks, insurance companies, mutual funds, segregated funds, pension funds, etc.) play many roles. As indicated earlier, they represent an important part of the "financial veil" through which savings is allocated to final

investment. In their activities involving the collection and deployment of funds for the ultimate benefit of their basic constituencies -- pensioners, policy holders, stock holders, etc., they operate within various legal and regulatory frameworks to pursue high rates of return on their investment decisions. For many of them, fiduciary responsibilities, at the same time, require prudence and soundness in the management of their investment assets, so that obligations to constituents are not placed at undue risk.

The total financial assets of the financial intermediaries as measured by Statistics Canada now constitute an "investment pool" of well over $600 billion. This is estimated to be about 30 per cent of all financial assets in Canada -- a proportion that has risen from not much over 20 per cent a quarter of a century ago. This increase is a very rough measure of the increased role of the financial intermediaries in their activities of allocating and re-allocating capital to investors.

In relative terms, the rate of growth of the financial assets of all Canadian pension funds has been even faster, since they have risen from just over 12 per cent to close to 17 per cent of those of all financial intermediaries over the same period. It has been officially estimated that the total financial assets of public and private funds in Canada were slightly above $100 billion in 1985. The Ontario Public Sector Pension Funds therefore account for only a rather small proportion of the total financial assets of all financial intermediaries.

The Role of the Ontario Public Sector Pension Funds

Although relatively small, the financial assets of the Ontario Public Sector Pension Funds have been growing rapidly. An overwhelming concern in the management of these assets must be about their best use for benefitting present and future retired employees from the Ontario public sector. But it is appropriate to ask whether, consistent with this objective, a larger and growing role could be played by these Funds in Ontario's economic enhancement.

In the context of the views about economic enhancement expressed above -- and even more particularly, in the context of the above views about the role that financial intermediaries and financial markets employ in helping to allocate savings to more productive uses -- widening the scope of the investment activities of these Funds would appear to deserve careful consideration. The present heavy concentration of the assets of these Funds in nonmarketable government securities suggests that there is a potentially larger and more wide-ranging role for these Funds to play in the overall development of the Ontario economy.